Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:KYT:NAS:TL-N-2960-00
HPLevine, ID# 62-09574

date: JUN 2 8 2000

to: District Director, Kentucky-Tennessee District
Engineer Harry G. Craig

from: District Counsel, Kentucky-Tennessee District, Nashville

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subject: **Legal sufficiency of valuation reports**

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ISSUES:

1. Whether the taxpayer's attempts to identify building components and determine the fair market value of [redacted] that it purchased through the valuations are legally sufficient?

2. What can and should the Internal Revenue Service do to attempt to determine the appropriate methodology for valuing the assets?

CONCLUSIONS:

1. The taxpayer's attempts to identify building components and determine the fair market value of [redacted] that it purchased through the valuations are not legally sufficient.

2. The Internal Revenue Service should attempt to work with the taxpayer to develop a methodology to properly value the assets.

FACTS AND DISCUSSION:

The taxpayer is a public corporation which operates a [redacted] group of [redacted]. It has grown to its current size through acquisitions of existing [redacted]. This manner of growth is prevalent in the [redacted] field. It purchased [redacted] in the current cycle. Cost segregation studies were prepared which purported to identify the building components and determine the fair market value of the [redacted] for depreciation purposes. There is some indication that the purchases were below fair market value. Fair market value of the building components was determined through estimates of replacement value using cost estimating manuals. The residual amount was assigned to the real property. Depreciation of the building and components were done on a pro-rata basis. There are many problems with the reports which were identified in the engineering report of [redacted] which was produced in the prior cycle.

The burden of proof on establishing a deduction is on the taxpayer. The burden requires the taxpayer to establish not only that the Internal Revenue Service's determination is incorrect, but also the amount of the correct deduction. Boddie-Noell Enterprises, Inc. v. United States, 96-2 USTC ¶ 50,627 (USCtFed.Claims 1996). For issues involving valuation, this includes establishing that the property valuation is reasonably accurate. Id. The taxpayer's burden on valuation issues need not be mathematically precise. Rather, valuation is necessrily an approximation and the valuation will be sustained if it is within the range of figures that may properly be deduced from the evidence. Lanier v. Commissioner, T.C. Memo. 1998-7 and cases cited therein; Jacobs v. Commissioner, T.C. Memo. 1998-204 and cases cited therein.

The taxpayer must establish entitlement to the deduction through competent evidence. It need not do so with precision. Although you believe that the National Office suggested otherwise in Letter Ruling 199921045 when it stated that the cost segregation study could not be based on non-contemporaneous records, reconstructed data or estimates or assumptions, we do not believe that the facts relied upon in that case are the same as those involved here. The National Office based its conclusion on language in Boddie-Noell Enterprises, Inc. v. United States, supra. The facts in the Boddie-Noell Enterprises, Inc. case however involved a claim for investment tax credit by the ***original*** purchaser. The taxpayer attempted to reconstruct its cost through approximations and the court determined that records establishing the original cost were the best evidence of the cost. Moreover, the court suggested the obvious - that unreliable valuations are unpersuasive. In this regard, the taxpayer in Boddie-Noell Enterprises, Inc. v. United States, supra, attempted to reconstruct its cost as a percentage of property eligible for investment tax credit based on cost reports of similar but unrelated properties. See also Nestle Holdings, Inc. v. Commissioner, T.C. Memo. 1995-441, aff'd in part and rev'd in part, 152 F.3d 83 (2d Cir. 1996) (valuation based on factual circumstances in other cases is not a reliable indicator of value). Consequently, since the [redacted] were purchased by this taxpayer for lump-sum amounts and valuation of the [redacted] necessarily involves both a fair market valuation and a determination of the separate components which establish the purchase price, we do not believe that it is fatal under the facts of this case that the taxpayer seeks to value the properties through replacement cost estimation. The crucial factor is the reliability of the determinations.[1]

The burden to the taxpayer in this type of case is not inconsequential. Although component depreciation was eliminated before the taxable year at issue and therefore, is not at issue in this case, the factors are equally applicable. Component method to determine depreciation on used real property was allowable only "if the cost of acquisition is properly allocated to the various components based on their value and useful lives

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[1] This is not to suggest that the blanket disallowance by the Internal Revenue Service in the earlier cycle was incorrect. The taxpayer has the burden of establishing entitlement to the deductions. For depreciation purposes, this includes the purchase price and useful life. To the extent that it does not do so, then it is conceivable that the taxpayer will not be allowed any deductions although it is undisputed that the taxpayer purchased assets which were subject to depreciation.

are assigned to the component accounts based on the condition of such components at the time of acquisition." Fieland v. Commissioner, 73 T.C. 743, 752 (1980); Milbrew, Inc. v. Commissioner, T.C. Memo. 1981-610; Rev. Rul. 73-410, 1973-2 C.B. 53. This is the same burden that the taxpayer faces in this case. The Tax Court has acknowledged that determining the precise cost to the purchaser of the individual components cannot be made and the difficulties in attempting to do so with the requisite amount of accuracy. Milbrew, Inc. v. Commissioner, T.C. Memo. 1981-610; Lesser v. Commissioner, 42 T.C. 688, 704-06 (1964), aff'd, 352 F.2d 789 (9th Cir. 1965), cert. denied, 384 U.S. 927 (1966).

The taxpayer has the burden of proving that the Internal Revenue Service's fair market valuation is incorrect. Lanier v. Commissioner, supra. Expert opinions which aid the court in the determination will be given weight commensurate with the veracity of their underlying basis. The court can selectively accept or reject whatever portions of the report that it believes bears on its judgment. Id. The taxpayer has the burden of proof on establishing entitlement to the depreciation deductions which in this case involves a reliable determination of fair market value. Based on the identified flaws, the Internal Revenue Service can disallow the deductions without proposing an alternative value. However, by doing so, the Internal Revenue Service runs the risk that the court may accept the taxpayer's report or sufficient portions of the report without adequate input from the Internal Revenue Service. See for example, Newark Morning Ledger Co. v. United States, 507 U.S. 546 (1993), where the court accepted the taxpayer's valuation because the "Government failed to offer any evidence to challenge the accuracy" of the taxpayer's application of the method.

We agree that there are severe flaws in the taxpayer's valuation methodolgy. Many are recurring from valuations in prior cycles. This no doubt is because the same valuation "experts" were used. It further appears that the taxpayer starts from a flawed premise, that is, that the purchase price represents fair market value. While this is generally true for unrelated parties, it is not always true particularly if one party was under a compulsion to buy or sell. In this regard, you question whether the purchase price represented fair market value. Since the residual amount was allocated to real property, starting with an amount below fair market value will overallocate the value to the personal depreciable property and underallocate the amount to land and depreciable real property. See Barker v.

United States, 668 F.Supp. 1199 (CD Ill. 1987).[2] This we agree is not acceptable for deductibility purposes.[3]

Since the expert reports provided by the taxpayer are inadequate, the remaining question is what is adequate and how the parties can make this determination. We first suggest that you determine how the parties in the transaction determined the price at which the assets were sold for. You should start by reviewing the contract. In this regard, there may be some friction between the taxpayer and the seller due to their competing interests. The seller would want to allocate as much of the sales price as possible to nondepreciable assets such as land. Otherwise, they run the risk of having to report a gain on the sale especially for those assets which were designated as 5 or 7 year MACRS properties with generally fast write-offs. The basis of those assets would therefore generally be low due to the accelerated depreciation taken. To avoid this, the parties may have allocated the purchase price separately to the land, tangible real estate and building components.[4] In addition, you

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[2] It appears that the replacement cost method was incorrectly applied as a matter of law. The replacement cost approach begins with an estimation of the value of the underlying land and then adds the cost of constructing equivalent improvements as if they were new. The physical depreciation or obsolescence for the diminution in value is then subtracted. Marine v. Commissioner, 92 T.C. 958, 983 (1989), aff'd without published opinion, 921 F.2d 280 (9th Cir. 1991); Lanier v. Commissioner, T.C. Memo. 1998-7. The cost segregation reports prepared for the taxpayer appear to have been done in reverse order. The value of the components and the building were first determined with the remainder allocated to the land.

[3] As a preliminary matter, replacement cost can only be considered in valuing property where a probative correlation between such cost and fair market value is established. Jacobs v. Commissioner, T.C. Memo. 1998-204. In this regard, a correlation is generally established where the property is unusual and other valuation methods are not applicable because of the property's uniqueness and non-income producing nature. Id. As pointed out in the Internal Revenue Service engineering report in the earlier cycle, both the I.R.C. § 1245 personal property and I.R.C. § 1250 property were depreciated for replacement cost purposes on the same basis. Although tax depreciation has separate objectives than actual depreciation, they are premised on similar concepts.

[4] You may also want to determine how the seller reported the sales on its income tax returns. They may have relied on the

may want to determine what valuation method if any was used to determine the purchase price and whether there are formal or informal valuations to support the purchase price.

Determining the valuation of each of the [redacted] and allocating the purchase price to the land, building and building components may be very expensive and time consuming for both the taxpayer and the Internal Revenue Service. Assuming arguendo that the [redacted] properties are sufficiently similar, you may want to consider whether it is feasible to enter into an agreement with the taxpayer to jointly value one property and apply the conclusions to the other properties. For example, the parties could jointly agree to select one property with a fair market valuation done on the property. The fair market valuation can then be allocated between the depreciable and non-depreciable assets, that is land and non-land assets. The non-land assets (buildings and building components) could then be valued separately. For those items in dispute between the taxpayer and the Internal Revenue Service, such as whether they constitute building components or I.R.C. § 1245 personal property, percentages can be developed of the total cost of the depreciable property which could then be applied to the other properties.

The valuations suggested herein could either be done jointly with the taxpayer through the procurement of a mutually agreed third-party appraiser or by separate valuations between the taxpayer and the Internal Revenue Service with the Internal Revenue Service using in-house experts. In this latter event, the Internal Revenue Service would have to develop a methodology for critiquing the taxpayer's valuation report. This would have to be agreed to by the taxpayer to be meaningful.[5] This could

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same valuation reports. While the Internal Revenue Service would not be bound to accept consistent treatment between the buyer and seller, this may reduce the risk exposure that the Internal Revenue Service has. But see Barker v. United States, 668 F.Supp. 1199 (USDC, C.D. Ill. 1987) (arms-length negotiations which are adversarial such that both have things to gain and lose must be accepted by the Internal Revenue Service where the result is equitable to both parties to the transaction).

[5] It appears from our electronic research that [redacted], the firm that performed the valuations for the taxpayer has testified for the Government on occasion. See [redacted]. The taxpayer may attempt to use the Government's prior use of the valuation firm as an informal admission of reliability. For purposes of this case, this merely means that the Internal Revenue Service should be

include for instance, an agreement that the land, building, building components and personal property would be separately valued to arrive at fair market value. The fair market value would then have to be compared to the purchase price to determine the percentage applicable to the separate components of the purchase price. The objective of course is to allow the parties to focus on the legal (as opposed to factual) issues which are involved, those being the determination of whether the separate items are building components or personal property.[6]

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prepared to establish to the court that the reports should be rejected either by establishing the weaknesses and their impact on the report (from discounts to total repudiation) or by affirmatively establishing the values through expert valuations. The court can reject a report in toto where the reliability is severely compromised because of errors. Lanier v. Commissioner, T.C. Memo. 1998-7.

[6] Should you determine that it is not feasible to work with the taxpayer or should the taxpayer not agree to do so, then an alternative would be for the Internal Revenue Service to value the material assets, that is, the land, building and specific components that make up a material amount of all of the components. This approach would tend to be more in the nature of a rebuttal position since it may establish the unreliability of the taxpayer's reports. You could also consider grouping assets with similar cost and depreciation characteristics and then valuing the material items in the group in an attempt to develop a more plenary valuation.

Please contact the undersigned at (615) 250-5072 if you have any questions. Attached is a client survey which we request that you consider completing. We are requesting post-review from the National Office because of the interpretation of Letter Ruling [redacted]. In the interim, we suggest that you discuss this matter with the team leader and group manager in order to determine the methodology in which the Internal Revenue Service should proceed. We will keep our file open to further assist you in the short-term in the valuation methodology and in the long-term on asset classifications for building component or I.R.C. § 1245 property.

JAMES E. KEETON, JR.
District Counsel

By: ____________________
HOWARD P. LEVINE
Senior Attorney

Attachment:
Client Survey

cc: Steve White/Jim Delacey

cc: ARC (LC) Don Williamson
(Via e-mail)

cc: ARC (TL) Roy Allison
(Via e-mail)